[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-130675-17]

RIN 1545-BO06

Definition of Foreign Currency Contract Under Section 1256

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that define the term "foreign currency contract" under section 1256 of the Internal Revenue Code (the "Code") to include only foreign currency forward contracts. The proposed regulations affect certain holders of foreign currency options.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-130675-17) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury ("Treasury Department") and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket.

Send paper submissions to: CC:PA:LPD:PR (REG-130675-17), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044.

A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the Federal Register. For those requesting to speak during the hearing, send an outline of topic submissions electronically via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-130675-17).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, D. Peter Merkel or Karen Walny at (202) 317-6938; concerning submissions of comments or requests for a public hearing, Regina L. Johnson at (202) 317-5177 (not toll-free numbers) or by sending an email to publichearings@irs.gov.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations that would provide that the term foreign currency contract as defined in section 1256(g)(2) of the Code applies only to a foreign currency forward contract.

I. Statutory Development of Section 1256

A. Section 1256 Generally

Section 1256(a)(1) provides that each section 1256 contract held by a taxpayer at the close of the taxable year is treated as sold for its fair market value on the last business day of that taxable year (and any gain or loss is taken into account for the taxable year). Section 1256(a)(2) provides that proper adjustment must be made in the amount of any gain or loss subsequently realized to take into account the gain or loss previously recognized under section 1256(a)(1). Generally, section 1256(a)(3) provides

that any gain or loss on a section 1256 contract is treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss (“60/40 treatment”).

Section 1256(b)(1) defines a section 1256 contract as any regulated futures contract, any foreign currency contract, any nonequity option, any dealer equity option, and any dealer securities futures contract. Section 1256(b)(2) excludes the following contracts from the definition of a section 1256 contract: (1) any securities futures contract or option on such a contract unless it is a dealer securities futures contract, or (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.

Section 1256(g)(2)(A) defines the term foreign currency contract as a contract that (1) requires delivery of, or the settlement of which depends on the value of, a foreign currency which is a currency in which positions are also traded through regulated futures contracts, (2) is traded in the interbank market, and (3) is entered into at arm's length at a price determined by reference to the price in the interbank market. Section 1256(g)(2)(B) grants the Secretary authority to prescribe regulations as may be necessary or appropriate to carry out the purposes of the foreign currency contract definition, including the authority to exclude any contract or type of contract from that definition if it would be inconsistent with those purposes.

Section 1256(g)(3) defines the term nonequity option as any listed option (generally, an option traded on or subject to the rules of a qualified board or exchange) that is not an equity option.

Section 1256(f)(2) provides that 60/40 treatment does not apply to gain or loss that otherwise would be ordinary. Section 988(a)(1) provides that if a futures contract, forward contract, option, or similar financial instrument is a section 988 transaction, the gains and losses from the transaction are treated as ordinary, absent an election for

certain transactions. However, regulated futures contracts and nonequity options that are marked-to-market under section 1256 are not section 988 transactions unless a taxpayer makes an election to treat the contract as a section 988 transaction. See section 988(c)(1)(D)(i) and (ii).

B. Scope of Section 1256 When Enacted in 1981

When it was enacted in 1981, section 1256 applied only to regulated futures contracts, including regulated futures contracts involving foreign currency. See Economic Recovery Tax Act of 1981 ("ERTA"), Public Law 97-34 (95 Stat. 172, section 503(a) (1981)). One of the hallmarks of regulated futures contracts is the daily cash settlement, mark-to-market system employed by U.S. futures exchanges to determine margin requirements. In contrast to U.S. futures exchanges, the interbank market and other over-the-counter ("OTC") markets did not employ a daily cash settlement, mark-to-market system for margin requirements.

C. Technical Corrections Act of 1982

As originally enacted, section 1256 applied to regulated futures contracts requiring the delivery of foreign currency, but not to similar foreign currency forward contracts that were traded in the OTC market rather than on an exchange. In 1983, Congress extended the application of the statute to foreign currency contracts traded in the interbank market and provided a definition in section 1256(g)(1) for the term foreign currency contract. See Technical Corrections Act of 1982, Public Law 97-448, section 105(c)(5)(B) and (C) (96 Stat. 2365 (1983)). In adding section 1256(g)(1), Congress specified that the term foreign currency contract included only a contract that requires delivery of the foreign currency.

The legislative history explains that this expansion was grounded in the economic comparability of trading foreign currency through forward contracts in the interbank market to trading foreign currency through regulated futures contracts and the

interchangeability of the two types of contracts by traders. H.R. Rep. No. 97-794, at 23 (1982). In addition, the pricing of these foreign currency forward contracts was readily available because they trade through the larger, liquid interbank market. Id. Nothing in the statute or legislative history indicates Congress intended to include option contracts, which are not generally economically comparable to regulated futures contracts. Moreover, while the definition of foreign currency contract enacted in 1983 required the delivery of foreign currency, option contracts will not always result in settlement (either by physical delivery or delivery of the cash equivalent value).

D. Deficit Reduction Act of 1984

In 1984, Congress further expanded the types of contracts to which section 1256 applied to include nonequity options and dealer equity options. See Deficit Reduction Act of 1984, Public Law 98-369 at section 102(a)(3) (98 Stat. 494 (1984)). It also amended the definition of a foreign currency contract to allow for cash settlement. Id. The Deficit Reduction Act of 1984 also added section 1256(g)(2)(B), which provides the Treasury Department with authority to issue regulations that are necessary or appropriate to carry out the purposes of the foreign currency contract definition. Id.

Before this 1984 amendment, the term foreign currency contract applied only to contracts that required the physical delivery of the foreign currency. However, the futures contract and forward contract market had developed in a manner that no longer required physical delivery. Instead, contracts permitted the parties to settle contracts for their cash equivalent value. The definition of regulated futures contract was amended in 1983 to remove the requirement of delivery of personal property. See H.R. Conf. Rep. 97-986, at 26-27 (1982). The amendment to the definition of foreign currency contract in 1984 was intended similarly to treat the delivery requirement as met where the contract provides for a settlement determined by reference to the value of foreign

currency. Specifically, the House Report explained the reason for the 1984 amendment as follows:

> PRESENT LAW
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> The Technical Corrections Act of 1982 provided that certain foreign currency contracts entered into after May 11, 1982 (or earlier, if certain elections were made) will be treated as regulated futures contracts and therefore be taxed on the marked-to-market system with a maximum tax rate of 32 percent. In order for a contract to qualify as a foreign currency contract, the contract must require delivery of a foreign currency which is a currency in which positions are also traded through regulated futures contracts.
>
> EXPLANATION OF PROVISION
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> Because certain contracts may call for a cash settlement by reference to the value of the foreign currency rather than actual delivery of the currency, the bill provides that the delivery of a foreign currency requirement is met where the contract provides for a settlement determined by reference to the value of the foreign currency.

H.R. Rep. 98-432 Part 2, at 1646 (1984). At the same time, Congress addressed foreign currency options by adding nonequity options to the list of section 1256 contracts, as described above. Consequently, listed foreign currency options became subject to section 1256 by explicit Congressional action. While the legislative history expressly stated that Congress amended the definition of a foreign currency contract to include cash-settled foreign currency forward contracts, the legislative history does not indicate that Congress intended also to expand the scope of section 1256 to include OTC foreign currency options regardless of whether they may be cash-settled.

E. Technical and Miscellaneous Revenue Act of 1988

The legislative history with respect to a 1988 amendment to section 988 also indicates that Congress understood that a foreign currency contract, as defined by section 1256(g)(2), does not include a foreign currency option. Section 988 generally applies to forward contracts, futures contracts, options, and similar financial instruments if the amount that a taxpayer is entitled to receive or is required to pay is denominated in terms of a nonfunctional currency or determined by reference to the value of one or

more nonfunctional currencies. See section 988(c)(1)(A) and (B)(iii); see also section 988(c)(1)(D) (providing an exception to section 988(c)(1)(B)(iii) for certain regulated futures contracts and nonequity options). In 1988, Congress amended section 988 to add section 988(c)(1)(E). Technical and Miscellaneous Revenue Act of 1988, Public Law 100-647, at section 6130(b) (102 Stat. 3342 (1988)). Section 988(c)(1)(E) provides that any instrument described in section 988(c)(1)(B)(iii) (that is, any forward contract, futures contract, option, or similar financial instrument) is not a section 988 transaction if it is held by certain partnerships (each, a "qualified fund") and would be marked to market under section 1256. Section 988(c)(1)(E)(iv)(I) further provides that any bank forward contract, any foreign currency futures contract traded on a foreign exchange, or any similar instrument to the extent provided in regulations that is not otherwise a section 1256 contract is treated as a section 1256 contract for purposes of section 1256 when held by a qualified fund.

The legislative history indicates that Congress believed that the term foreign currency contract generally meant bank forward contracts on foreign currency, and that OTC foreign currency options were not already section 1256 contracts. See H.R. Conf. Rep. No. 100-1104 (Vol. 2), at 189, reprinted in 1988-3 C.B. 473, 679 ("[T]he [conference] agreement expands the definition of section 1256 contracts to generally include … bank forwards: that is, foreign currency contracts (as that term is defined in section 1256(g)(2) of the Code), and [certain other contracts] …. [T]he [conference] agreement provides the Treasury with regulatory authority to treat other similar instruments (for example, options) held by qualified funds as section 1256 contracts.") (emphasis added).

II. Listed Transactions Using Offsetting Foreign Currency Options

Taxpayers entered into tax avoidance transactions that relied upon treating OTC foreign currency options, in a currency in which regulated futures were traded, as

section 1256(g)(2) foreign currency contracts. On December 22, 2003, the IRS published Notice 2003-81, 2003-51 I.R.B. 1223, which identified a tax avoidance transaction involving offsetting foreign currency options. This transaction is often referred to as a "major-minor" transaction because it involved the taxpayer purchasing call and put options in a "major" foreign currency (one in which regulated futures contracts traded) and writing call and put options in a "minor" currency (one in which regulated futures contracts were not traded). The purchased and written foreign currency options were in two different currencies that historically had a high positive correlation, such that the taxpayer could be reasonably certain to have offsetting gains and losses in the options. The taxpayer treated its major currency options as foreign currency contracts under section 1256(g)(2) and treated its options on the minor currency as not subject to section 1256. When there was unrecognized gain and loss on the options, the taxpayer assigned the purchased major currency option with a loss to a charity, and the charity assumed the offsetting written minor currency option from the taxpayer (the taxpayer, however, retained the premium received on the written option). The taxpayer treated the assignment of the major currency option as a mark-to-market recognition event under section 1256(c), claiming a loss upon the assignment. However, the taxpayer did not report the recognition of gain on the offsetting minor currency option assumed by the charity because the option was a non-section 1256 contract and the taxpayer treated the assumption as a non-recognition event. The "Facts" section of Notice 2003-81 stated, without legal analysis, that the purchased major currency options were foreign currency contracts within the meaning of section 1256(g)(2)(A) because the major currency was traded through regulated futures contracts. Notice 2003-81 identified this transaction as a listed transaction and indicated that the taxpayer would be required under the Code to account for the gain

attributable to the premium originally received by the taxpayer for writing the minor currency option.

On August 27, 2007, the IRS published Notice 2007-71 (2007-35 I.R.B. 472), which modified and supplemented Notice 2003-81. Notice 2007-71 explained that "foreign currency options, whether or not the underlying currency is one in which positions are traded through regulated futures contracts, are [not] foreign currency contracts as defined in § 1256(g)(2)." Notice 2007-71 explained that the "Facts" section of Notice 2003-81 included "an erroneous conclusion of law." Notice 2007-71 corrected this error in the "Facts" section of Notice 2003-81, stating that the pertinent sentence should have read as follows: "'The taxpayer takes the position that the purchased options are 'foreign currency contracts' within the meaning of §1256(g)(2)(A) of the Internal Revenue Code and §1256 contracts within the meaning of §1256(b).'"

III. Judicial Interpretations of Section 1256(g)(2)

The IRS challenged taxpayers' characterization of the major-minor transactions in several cases before the United States Tax Court ("Tax Court"). In a series of rulings on motions for partial summary judgment, the Tax Court held that foreign currency options were not "foreign currency contracts" under section 1256. In one case, however, the Sixth Circuit disagreed and held that a foreign currency option could be a foreign currency contract.

A. Summitt v. Commissioner

The IRS successfully challenged the listed transactions described in Notice 2003-81 in Summitt v. Commissioner, 134 T.C. 248 (2010). The Tax Court held that a foreign currency option is not a foreign currency contract as defined by section 1256(g)(2).

Explaining that the plain meaning of the statutory language controls the decision, the Tax Court held that the term foreign currency contract does not include an option

contract and that the major currency option was not subject to the mark-to-market rules of section 1256. Id. at 264, 266. The court noted that forwards and options confer different rights and obligations to the parties to these contracts. Id. at 264. The court found that it was clear that the words "or the settlement of which depends on the value of" in section 1256(g)(2)(A)(i) meant that a foreign currency contract must require settlement at expiration and that the reference in the statute to settlements was included to permit a foreign currency contract to be physically settled or cash-settled. Id. at 265. In contrast, an option may expire without any settlement occurring. The court further observed that "[t]here is no evidence in the legislative history that a literal reading of the statute will defeat Congress' purpose in enacting it." Id.

Subsequently, the Tax Court followed its decision in Summitt in two other cases. See Garcia v. Commissioner, T.C. Memo. 2011-85; Wright v. Commissioner, T.C. Memo. 2011-292. In both cases, the Tax Court noted that the taxpayers did not show a material factual difference between their cases and the earlier Tax Court opinion on the same issue. Garcia, T.C. Memo. 2011-85; Wright, T.C. Memo. 2011-292.

B. Wright v. Commissioner

The taxpayer appealed the Tax Court's decision in Wright. The Sixth Circuit reversed the Tax Court, holding that a foreign currency option could be a foreign currency contract based on the plain meaning of section 1256(g)(2). Wright v. Commissioner, 809 F.3d 877, 885 (6th Cir. 2016). Specifically, the Sixth Circuit found that the plain language of section 1256(g)(2)(A)(i) ("which requires delivery of, or the settlement of which depends on the value of, a foreign currency which is a currency in which positions are also traded through regulated futures contracts") does not require settlement. Id. at 883. The court reasoned that the plain meaning of section 1256(g)(2)(A)(i) provides that a "foreign currency contract" is "(1) 'a contract ... which requires delivery of ... a foreign currency' or (2) 'a contract ... the settlement of which

depends on the value of ... a foreign currency.'" Id. Therefore, it found that a contract is a "foreign currency contract" if the settlement of the contract depends on the value of a foreign currency, even if the contract does not mandate settlement. Id. In concluding that the statutory language in section 1256(g)(2)(A) was unambiguous, the Sixth Circuit noted that the Treasury Department and the IRS had express authority to change this result for future taxpayers. Id. at 885.

Explanation of Provisions

Under the authority of section 1256(g)(2)(B), and to carry out the purposes of section 1256(g)(2)(A), these proposed regulations provide that only a forward contract on foreign currency is a "foreign currency contract" as defined in section 1256(g)(2). The legislative history to section 1256, as discussed in part I of this preamble, indicates that Congress's purpose in amending the definition of foreign currency contract in 1984 was merely to include cash-settled foreign currency forward contracts within the definition of foreign currency contract. It would be inconsistent with this purpose to construe the term foreign currency contract as including options or other derivatives.

These proposed regulations do not change the status of foreign currency options that otherwise qualify as section 1256 contracts. Specifically, nonequity options are separately listed as section 1256 contracts in section 1256(b)(1)(C). Section 1256(g)(3) provides that a nonequity option is any listed option which is not an equity option. Section 1256(g)(5) defines a listed option as "any option . . . which is traded on (or subject to the rules of) a qualified board or exchange." Therefore, a foreign currency option that is listed on a qualified board or exchange is a "nonequity option" and remains subject to section 1256.

These proposed regulations do not define the term forward contract. For purposes of these proposed regulations, whether a derivative contract is properly characterized as a forward contract for U.S. federal income tax purposes is determined

under current law. In addition, the IRS may consider applying existing anti-abuse rules and judicial doctrines to a contract and any related transactions in order to evaluate whether a transaction is properly characterized as a forward contract or whether a transaction characterized as some other type of derivative contract should be treated as a forward contract.

Proposed Applicability Date

These proposed rules are proposed to apply to contracts entered into on or after the date that is 30 days after the date of publication of the Treasury decision adopting these proposed rules as final regulations in the **Federal Register** (the "proposed applicability date"). This proposed applicability date is intended to provide taxpayers in the Sixth Circuit with time to transition from the holding in Wright v. Commissioner to the rule described in these proposed regulations. However, for contracts entered into before the proposed applicability date by taxpayers in other circuits, the IRS intends to continue to adhere to its prior published position that foreign currency options are not foreign currency contracts under section 1256(g)(2). See Notice 2007-71, 2007-35 I.R.B. 472. A taxpayer may rely on these proposed regulations for taxable years ending on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, provided the taxpayer and its related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), consistently follow the proposed regulations for all contracts entered into during the taxable year ending on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** through the proposed applicability date of the final regulations.

Special Analyses

I. Regulatory Planning and Review – Economic Analysis

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the

Department of the Treasury and the Office of Management and Budget regarding review of tax regulations.

II. Regulatory Flexibility Act

The proposed rule affects any taxpayer that enters into a foreign currency option contract in the interbank market and that would otherwise treat the option as a "foreign currency contract" within the meaning of section 1256(g), contrary to the position set forth by the IRS in Notice 2007-71. No data is available about the number of small entities that are taking such a position. However, the Secretary has determined that the economic impact on any small entities affected by the proposed rule would not be significant.

The proposed rule clarifies that a "foreign currency contract" as defined in section 1256(g)(2) means only a foreign currency forward contract (and not a foreign currency option contract). The proposed rule does not require taxpayers to collect additional information to determine whether section 1256 applies to the taxpayer's option contracts. Taxpayers that would have otherwise reported these over-the-counter foreign currency options on IRS Form 6781 (Gains and Losses from Section 1256 Contracts and Straddles) as section 1256 contracts may collect less information under the proposed rule since the options will not be treated as section 1256 contracts. In addition, the proposed rule does not impose any new costs on taxpayers since it reaffirms the IRS's published position that over-the-counter foreign currency options are not "foreign currency contracts" within the meaning of section 1256(g). Similarly, the proposed rule does not affect a taxpayer's reporting obligation with respect to over-the-counter foreign currency options since the same amount of information is required to be reported.

In accordance with the Regulatory Flexibility Act (5 U.S.C. 601 et seq.) the Secretary hereby certifies that this proposed rule, if adopted, will not have a significant

economic impact on a substantial number of small entities. The Treasury Department and the IRS invite comment from members of the public about potential impacts on small entities.

III. Section 7805(f)

Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (“UMRA”) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This proposed rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. These proposed regulations do not have federalism implications and do not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive order.

Statement of Availability of IRS Documents

IRS notices and other guidance cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at http://www/irs.gov.

Comments and Request for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at www.regulations.gov or upon request.

A public hearing will be scheduled if requested in writing by any person that timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically by sending an email to publichearings@irs.gov. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**.

Announcement 2020-4, 2020-17 I.R.B. 667 (April 20, 2020), provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

Drafting Information

The principal authors of these regulations are D. Peter Merkel and Karen Walny of the Office of Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

PART 1–INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

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Section 1.1256(g)-2 also issued under 26 U.S.C. 1256(g)(2)(B).

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Par. 2. Section 1.1256(g)-2 is added to read as follows:

§1.1256(g)-2 Foreign currency contract defined.

(a) Foreign currency contract. For purposes of section 1256, the term *foreign currency contract* means a forward contract that—

(1) Requires delivery of, or the settlement of which depends on the value of, a foreign currency that is a currency in which positions are also traded through regulated futures contracts;

(2) Is traded in the interbank market; and

(3) Is entered into at arm's length at a price determined by reference to the price in the interbank market.

(b) Applicability date. This section applies to contracts entered into on or after [date 30 days after date of publication of the final rule in the **Federal Register**].

Paul J. Mamo,

Acting Deputy Commissioner for Services and Enforcement.

[FR Doc. 2022-14318 Filed: 7/5/2022 8:45 am; Publication Date: 7/6/2022]